



Blackgold Legal Pty Ltd	Lawchain Pty Ltd
ABN 95 616 899 524	ABN 716 643 078 95
35A Gipps Street	631 South Coree Road
Birchgrove NSW 2041	Finley NSW 2713

Director - Crypto Policy Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By Email: crypto@treasury.gov.au

Dear Director,

Token Mapping Consultation Paper 2023

We, BlackGold Legal and Lawchain, would like to express our gratitude for the opportunity to submit our joint response to the Australian Government's Token Mapping Consultation Paper 2023. Our firms are committed to providing exceptional advisory services to blockchain technology clients. As such, our responses to the questions raised in the Consultation Paper have been formulated with careful consideration and aim to provide greater clarity and certainty to the industry.

The Australian Government's Token Mapping Consultation Paper is a positive development towards understanding the tenets of the blockchain technology and cryptocurrency ecosystem and how regulation should operate within Australia. The blockchain technology and cryptocurrency ecosystem is a complex and ever-evolving landscape that is changing the way individuals, corporations and states transact, meaning there are unique challenges that need to be considered from a regulatory perspective.

Our responses to the questions raised in the Consultation Paper address these unique challenges and emphasise the importance of a regulatory model that is principles-based, attuned to technological advancements and one that upholds the importance of ensuring that Australia's framework is globally competitive. In our opinion, it is paramount that any proposed regulatory mechanisms balance the importance of protecting stakeholders whilst also fostering innovation within the blockchain technology and cryptocurrency ecosystem.

Whilst our responses have been tailored to the individual questions, we would like to emphasise that:

- (a) the blockchain technology and cryptocurrency ecosystem is increasingly complex and ever-evolving - it is fundamental that any future regulatory model integrates a nuanced approach that recognises key differences across blockchains and various digital asset classes;
- (b) whilst consumer and investor protection is paramount, those protections should be considered together with mechanisms to allow innovation and creativity within this nascent technology and preserving a key tenet of the blockchain technology and cryptocurrency ecosystem - decentralisation;
- (c) the benefits of mandatory disclosure regimes are multifaceted to stakeholders within the blockchain technology and cryptocurrency ecosystem;
- (d) the definition of what constitutes an “intermediary” within the blockchain technology and cryptocurrency ecosystem needs to be clearly defined and subject to stringent licensing, custody and compliance requirements; and
- (e) regulatory mechanisms should be implemented proportionally to the risk, size, complexity and systemic importance of various digital assets and their related technologies.

If you have any questions regarding the joint submission, please do not hesitate to contact the authors.

Yours Sincerely,

Consultation Questions and Responses

Q1) What do you think the role of the Government should be in the regulation of the crypto ecosystem?

We are of the opinion that the role of government in the regulation of the crypto ecosystem needs to strike a balance between supporting innovation, maintaining market integrity and ensuring adequate levels of consumer protection.¹ Moreover, given the nature of blockchain technology and cryptocurrency is highly dynamic and ever evolving, it is paramount that any regulation is inherently flexible.

As a starting point, our view is that the Australian government needs to establish a statutory framework that clearly articulates what assets, products and technologies should and what should not be regulated, and by whom. In drafting the legislation, it is paramount that the government consults with various stakeholders within the industry, including industry experts, lawyers and academics to ensure that key areas of concern are addressed.

In doing so, the legislature should take a nuanced approach to regulation that recognises differences across blockchains and digital asset classes. This is because the crypto ecosystem “encompasses a wide variety of experiments being conducted by many different stakeholders”², meaning it is conceptually and practically very difficult to attempt to “paint all digital assets with the same regulatory brush”.³ Importantly, we believe it is paramount that the government ensures that the legislation drafted is proportionate to the risk, size, complexity and systemic importance of differing digital assets.

Once the legislation is enacted, the government should work closely with the nominated regulatory body, or bodies, to create a system of regulatory practices that aligns with upholding innovation, market integrity and consumer protection. In our opinion, the use of a specialised and appropriately resourced regulator, whose sole mandate is to understand and regulate the blockchain technology and cryptocurrency ecosystem would be preferable. This was the approach taken by the government of Dubai with the establishment of its Virtual Asset Regulatory Authority (VARA) which has created a framework of bespoke rules and guidelines for virtual asset platforms, virtual asset service providers and other matters related to virtual assets.⁴

In our response to questions 2, we provide some practical examples of the areas of regulatory intervention that we consider appropriate to safeguard consumers and investors.

Q2) What are your views on potential safeguards for consumers and investors?

Our view is that consumers and investors need to be provided with a clear and concise framework of regulation that balances the importance of protection with that of maintaining the dynamism of the

¹ Bains, Parma, Arif Ismail, Fabiana Melo, and Nobuyasa Sugimoto. 2022. “*Regulating the Crypto Ecosystem: The Case of Unbacked Crypto Assets*.” IMF Fintech Note 2022/007, International Monetary Fund, Washington, DC. Available here: <https://www.imf.org/en/Publications/fintech-notes/Issues/2022/09/26/Regulating-the-Crypto-Ecosystem-The-Case-of-Unbacked-Crypto-Assets-523715>.

² Commissioner Hester M. Pierce, ‘*Outdated: Remarks before the Digital Assets at Duke Conference*’ (Speech, Washington D.C, 20 January 2023) Available here: <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>.

³ Ibid.

⁴ Government of Dubai, ‘Virtual Assets Regulatory Authority’, Available here: <https://www.vara.ae/en/#0>.

blockchain technology and cryptocurrency ecosystem. This is particularly important because consumers and investors should have the confidence in knowing that the Australian blockchain technology and cryptocurrency ecosystem provides adequate levels of protection, regardless of the digital asset of interest.

Notwithstanding this, our view is that it is essential that the tools or methods of regulation do not impede or restrict the hallmark of the ecosystem - decentralisation. As such, regulatory tools should preserve the self-executing, open-source and permissionless nature of decentralised blockchains. Some practical examples and suggestions of how regulation could seek to achieve these goals are set out below.

- **Mandating disclosure requirements:** consumers and investors should have the confidence in knowing that cryptocurrency issuers and service providers are required to make available all necessary information pertaining to how they operate, their interdependence with other cryptocurrency assets, features of any particular offering and the risk management protocols that exist.⁵ One practical example of how this could be achieved is through requiring prospective issuers offering a product over a certain monetary threshold to complete a mandatory disclosure document. The disclosure document could take a similar form required to be issued by franchisors to prospective franchisees under the Franchising Code of Conduct⁶ and could include details surrounding:
 - the technical details about the crypto asset;
 - the technology on which the crypto asset operates;
 - the rights of the asset or token being issued;
 - how the crypto asset will be issued and listed (and whether the services of market maker have been engaged); and
 - the risks involved in participating in the offering.

As part of a disclosure document, the directors of the issuer should be required to give a statement and or certification that the disclosure document presents a true and fair view of the digital asset or project. Importantly, just like the section 708(1) of the *Corporations Act*⁷ sets out criteria for small scale offerings of a company's securities (which does not require disclosure documents to be prepared), there should be a threshold, monetary or by number of entities to which the cryptocurrency assets are issued, under which disclosure documents are not required.

- **Promotion of marketing material relating to digital asset offerings:** Australian regulators could require cryptocurrency asset and product issuers to disclose risk warnings to consumers and investors, and ensure that promotional material is "clear, balanced and fair".⁸ In addition, the concept of ensuring that marketing materials are free from 'misleading and deceptive' representations (as under the Australian Consumer Law) could be clearly articulated to apply to cryptocurrency assets.

⁵ Bains, Parma, Arif Ismail, Fabiana Melo, and Nobuyasa Sugimoto. 2022. "Regulating the Crypto Ecosystem: The Case of Unbacked Crypto Assets." IMF Fintech Note 2022/007, International Monetary Fund, Washington, DC. Available here: <https://www.imf.org/en/Publications/fintech-notes/Issues/2022/09/26/Regulating-the-Crypto-Ecosystem-The-Case-of-Unbacked-Crypto-Assets-523715>.

⁶ *Competition and Consumer (Industry Codes - Franchising) Regulation 2014* - Schedule 1 s 8.

⁷ *Corporations Act 2001* (Cth) s 708.

⁸ Bains, Parma, Arif Ismail, Fabiana Melo, and Nobuyasa Sugimoto. 2022. "Regulating the Crypto Ecosystem: The Case of Unbacked Crypto Assets." IMF Fintech Note 2022/007, International Monetary Fund, Washington, DC. Available here: <https://www.imf.org/en/Publications/fintech-notes/Issues/2022/09/26/Regulating-the-Crypto-Ecosystem-The-Case-of-Unbacked-Crypto-Assets-523715>.

- **Mandating the standards for wallet and exchange providers:** whilst we acknowledge that this was the subject of the Treasury's *Crypto asset secondary service providers: Licensing and custody requirements* – Consultation Paper dated 21 March 2022, it is paramount that any future protection considers the regulation of third-party digital custodians. This could be achieved through working with wallet and exchange providers and setting a data collection protocol which regulates the storing, recording and reporting of consumers/investors information.

Importantly, we consider that any regulatory controls should be implemented proportionally to the risk, size, complexity and systemic importance of the digital asset offering.

Q3) Scams can be difficult for some consumers to identify. a) Are there solutions (e.g. disclosure, code auditing or other requirements) that could be applied to safeguard consumers that choose to use crypto assets? b) What policy or regulatory levers could be used to ensure crypto token exchanges do not offer scam tokens or more broadly, prevent consumers from being exposed to scams involving crypto assets?

a)

In attempting to safeguard the interests of consumers from scams in the blockchain technology and cryptocurrency ecosystem, we believe that the following solutions could be adopted:

1. **Disclosure Requirements:** as discussed in question 2, one solution to safeguard consumers using cryptocurrency assets could include requiring issuers of cryptocurrency assets to disclose all relevant information about their projects, including the team behind the project, the technology being used, and the risks involved. This could be facilitated by a mandatory questionnaire-style document for prospective issuers of cryptocurrency assets over a certain threshold.
2. **Mandatory presence within Australia for offerings over a certain threshold:** as an extension of the above example, a company or entity issuing cryptocurrency assets over a certain threshold could be required to have an onshore Australian presence; whether that be through an incorporated Australian company or a director who is based in Australia. From an accountability and enforcement perspective, this could help ensure that there is an identifiable or traceable path of redress for consumers and investors.
3. **Code Auditing:** this could be achieved by requiring issuers to undergo a code audit by an independent third-party auditor. This would ensure that the code used in the project is secure and free from vulnerabilities that could be exploited by bad actors. For example, in the case of a cryptocurrency project that is raising funds through an initial coin offering (ICO), requiring the project to disclose all relevant information about the project and undergo a code audit before launching the ICO could be an effective way to safeguard consumers.
4. **Crypto Asset Insurance:** requiring issuers of cryptocurrency assets to obtain insurance against losses incurred due to hacks or other cyber-attacks. This could provide an added layer of protection to consumers who choose to invest in cryptocurrency assets, although we recognise that this potential solution also requires the availability of suitable insurance policies at prices that are accessible.

b)

In our opinion, some examples of policy or regulatory levers which could be used to ensure cryptocurrency token exchanges do not offer scam tokens or to prevent consumers from being exposed to scams involving cryptocurrency assets could include:

1. **Listing Standards:** requiring Australian cryptocurrency token exchanges to implement listing standards that mandate that projects meet certain criteria before being listed on the exchange. In our experience exchanges have their own standards and listing criteria, however these are not uniform and are inconsistently applied. For example, exchanges could require projects to undergo a code audit or have particular certifications (for instance, ISO27001 certification in respect of an organisation's information security).
2. **Blockchain Based Verification Systems:** requiring exchanges to implement blockchain-based or other verification systems that verify the identity of token issuers (where tokens are issued by a centralised entity), which requirements could be similar to current KYC/AML requirements.⁹
3. **Establishment of a points-based system for certain cryptocurrency /token based projects:** on a practical level, this could be achieved through the establishment of a points system for these projects that is monitored by the appropriate regulatory body. For example, the points system could allocate point for each predetermined criteria relating to:
 - a. Risk
 - b. Disclosure
 - c. Interconnectedness
 - d. Liquidity
 - e. Code auditing
 - f. Crypto asset insurance
 - g. satisfaction of KYC/AML requirements

Consumers could use this confidence-based system to quickly assess the level of risk associated with the project and make informed investment decisions.

Q4) The concept of 'exclusive use or control' of public data is a key distinguishing feature between crypto tokens/crypto networks and other data records. a) How do you think the concepts could be used in a general definition of crypto token and crypto network for the purposes of future legislation? b) What are the benefits and disadvantages of adopting this approach to define crypto tokens and crypto networks?

a)

A cryptocurrency token could be defined as a digital representation of an asset or utility that is recorded on a decentralised network and can be transferred exclusively by the owner. Whereas a cryptocurrency network could be defined as a decentralised network that allows for the transfer and management of digital assets or utilities by the owners of those assets or utilities.

⁹ Under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth).

b)

The benefits of adopting this approach to define cryptocurrency tokens and cryptocurrency networks include increased legal certainty, improved investor protection, and enhanced market integrity. By establishing clear definitions and regulatory frameworks, investors and issuers would have greater confidence in the legitimacy and stability of the cryptocurrency market. Furthermore, this approach would enable regulators to better identify and address the risks associated with cryptocurrency tokens/networks, such as fraud and market manipulation.

However, there are also potential disadvantages to this approach. For example, some critics may argue that the 'exclusive use or control' concept is too narrow and fails to capture the full range of cryptocurrency assets and networks. Moreover, this approach could lead to increased compliance costs for issuers and limit innovation in the crypto space.

Q5) This paper sets out some reasons for why a bespoke 'crypto asset' taxonomy may have minimal regulatory value. a) What are additional supporting reasons or alternative views on the value of a bespoke taxonomy? b) What are your views on the creation of a standalone regulatory framework that relies on a bespoke taxonomy? c) In the absence of a bespoke taxonomy, what are your views on how to provide regulatory certainty to individuals and businesses using crypto networks and crypto assets in a non-financial manner?

a)

We support the establishment of a bespoke regime for the regulation of cryptocurrency assets for the following reasons:

- a. it is structurally designed to offer regulatory certainty – allowing the market to have greater clarity on the expected level of operator responsibility and the standards to be applied;
- b. it will create legal certainty amongst various stakeholders regarding what constitutes certain digital assets and the legal ramifications pertaining to ownership, licensing, possession and transfer;
- c. it will allow for the ecosystem to be technology neutral and supportive of innovation; and
- d. it will create a framework that provides greater levels of confidence amongst market participants.

Importantly, we believe that a bespoke taxonomy should be designed in a manner that is consistent with the broader regulatory objectives of the regulatory framework and should be subject to ongoing review and evaluation.

b)

Please refer to our response to question a) above.

c)

In the absence of a bespoke taxonomy, we believe that one way regulatory clarity could be given to individuals and businesses using cryptocurrency networks and cryptocurrency assets in a non-financial manner is through the issuance of regulatory guidelines, much like the regulatory guidelines issued by ASIC, giving practical guidance and examples for regulated entities.

Q6) Some intermediated crypto assets are ‘backed’ by existing items, goods, or assets. These crypto assets can be broadly described as ‘wrapped’ real world assets. a) Are reforms necessary to ensure a wrapped real-world asset gets the same regulatory treatment as that of the asset backing it? Why? What reforms are needed? b) Are reforms necessary to ensure issuers of wrapped real-world assets can meet their obligations to redeem the relevant crypto tokens for the underlying good, product, or asset?

a)

We do not believe that wrapped assets should always be painted using the same “regulatory brush”¹⁰ as the underlying asset that is behind it. Whilst we acknowledge that there are similarities between the two, there are also aspects that make them distinguishable from both a functionality and regulatory perspective. To use a well-known and clearly regulated example, a share in a listed real estate investment trust (REIT) is not regulated in the same fashion as the underlying real estate assets. From a regulatory perspective, we believe the treatment of wrapped assets needs to give consideration to functionality considerations surrounding minting, custody, bridging, liquidity and fractionalisation.

b)

Our view is that any regulatory reform should ensure that underlying assets are actually being held by the issuers of wrapped assets, whether that be through auditing procedures or some other means. In our experience, where investors and customers acquire a wrapped crypto asset, an expectation exists that there is some exposure to the underlying asset. As such, reforms should focus on the obligation of issuers to hold a minimum level of the underlying asset. This could be similar in nature to the EU Market in Crypto-assets (MiCA) proposed regulation which requires the allocation of key reserves and redemption plans in the case of distress, which are intended to guarantee that cryptocurrency -asset holders receive equivalent currencies.¹¹

In terms of the specific reforms needed, we recommend that regulators consider requiring issuers of wrapped assets to provide clear and transparent information about their underlying asset, including its ownership and custody arrangements. This could be achieved through greater disclosure obligations that require the issuers of wrapped assets to issue a document to individuals/prospective investors that details:

- the actual holdings of the underlying asset;
- information about the wrapped investment;
- the technology used; and
- the risks involved.

Additionally, a further mechanism could be through the appropriate regulator implementing its own standard auditing requirements that screens the level of ownership of the underlying asset in either a reserve facility or some other form of collateral to ensure that investors can redeem their tokens. Using Tether as an example, we note that concerns have been raised about whether Tether actually holds the

¹⁰ Commissioner Hester M. Pierce, ‘*Outdated: Remarks before the Digital Assets at Duke Conference*’ (Speech, Washington D.C, 20 January 2023) Available here: <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>.

¹¹ European Parliament, ‘EU Legislation in Progress: Markets in crypto-assets (MiCA) Available here: [https://www.europarl.europa.eu/RegData/etudes/BRIE/2022/739221/EPRS_BRI\(2022\)739221_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2022/739221/EPRS_BRI(2022)739221_EN.pdf).

reserves necessary to back its stablecoin. These concerns have led to calls for greater transparency and regulatory oversight of stablecoins, particularly those that are backed by real-world assets. In light of these concerns, we believe that reforms are necessary to ensure that issuers of wrapped real-world assets can demonstrate that they are actually holding or securing the underlying asset as claimed, and that they have the ability to meet their redemption obligations.

Q7) It can be difficult to identify the arrangements that constitute an intermediated token system. a) Should crypto asset service providers be required to ensure their users are able to access information that allows them to identify arrangements underpinning crypto tokens? How might this be achieved? b) What are some other initiatives that crypto asset service providers could take to promote good consumer outcomes?

a)

We acknowledge the importance of custody in relation to the provision of cryptocurrency asset services. It is our opinion that as soon as a service provider takes custody of any cryptocurrency assets (that is, as soon as they take receipt of a customer's assets, whether fiat or crypto assets), they should be subject to stringent obligations such as segregation of customer funds and fiduciary duties.

With regards to the identification of arrangements underpinning crypto tokens, we believe that cryptocurrency asset service providers should be required to ensure that their users have access to relevant information. This could include details regarding the ownership, custody, and transferability of the tokens, as well as any associated risks or limitations. To achieve this, cryptocurrency asset service providers could implement measures such as providing clear and comprehensive information on their websites or in their terms and conditions, or providing regular updates and reports to their customers.

Additionally, they could establish mechanisms for customers to request information or raise concerns, and ensure that staff are adequately trained and equipped to respond to such inquiries. Other initiatives that cryptocurrency asset service providers could implement to promote good consumer outcomes include the adoption of best practices in relation to security and risk management, such as implementing robust encryption and multi-factor authentication systems, conducting regular audits and assessments and establishing contingency plans for potential disruptions or breaches. They could also consider engaging with industry bodies and regulators to develop and promote standards and guidelines for the provision of cryptocurrency asset services, and participate in initiatives to educate consumers and promote awareness of the risks and benefits of using cryptocurrency assets.

b)

The recommendations outlined in our response to question 2 are also relevant to cryptocurrency asset service providers.

Q8) In addition to the functional perimeter, the Corporations Act lists specific products that are financial products. The inclusion of specific financial products is intended to both: (i) provide guidance on the functional perimeter; (ii) add products that do not fall within the general financial functions. a) Are there any kinds of intermediated crypto assets that ought to be specifically defined as financial products? Why? b) Are there any kinds of crypto asset services that ought to be specifically defined as financial products? Why?

a)

In our opinion, three kinds of intermediated cryptocurrency assets that ought to be specifically defined as financial products are:

1. **Stablecoins:** are a type of intermediated cryptocurrency asset that are pegged to a fiat currency, commodity, or other assets. Due to their supposed stable nature, they are often used as a medium of exchange, making them akin to traditional monetary instruments such as currencies or cash. Financial writer J.P. Koning however has argued that they are “prone to permanent breakage” because of their fragile reliance on a “circular relationship” between divergent actors—those who crave “stability” on the one hand and those who alternatively seek “high-return opportunities.”¹² Algorithmic stablecoins are unlikely to serve any true long-term, consumer welfare-enhancing, or financial inclusionary function other than short-term DeFi speculation¹³, which yields very little inclusionary or system-wide benefits. We believe their “instability threatens their usefulness,”¹⁴ and therefore raises the necessity for close regulation under the financial product definition.
2. **Asset-backed tokens:** are intermediated cryptocurrency assets that are backed by tangible assets, such as real estate, commodities, or other investments. As these tokens represent a claim on the underlying assets, they can be considered to have similar features to traditional investment products such as shares or units in a managed investment scheme. Defining asset-backed tokens as financial products would ensure that they are subject to the same regulatory requirements and investor protections as traditional investments.
3. **Utility tokens with investment features:** are intermediated cryptocurrency assets that are designed to provide access to a particular product or service, such as a platform or application. However, some utility tokens also have investment features, such as the potential for capital appreciation or revenue sharing. Defining these utility tokens as financial products would ensure that they are subject to the same regulatory requirements as traditional investment products, particularly in relation to disclosure and investor protections.

b)

We believe that there are three kinds of cryptocurrency asset services that ought to be specifically defined as financial products:

1. **Cryptocurrency asset custody:** involves the safekeeping and management of cryptocurrency assets on behalf of clients. As custody services involve the holding of financial assets, they should be considered financial products and subject to the same regulatory requirements as traditional custodial services.
2. **Cryptocurrency asset trading platforms:** facilitate the buying and selling of cryptocurrency assets, including cryptocurrency assets that are commodities, could be defined as financial

¹² J.P. Koning, *Algorithmic Stablecoins*, Am. Inst. Econ. Rsch. (Feb. 1, 2021) Available here: <https://www.aier.org/article/algorithmic-stablecoins/>.

¹³ Andrey Shevchenko, *Finance Redefined: The Curious Implications of Algorithmic Stablecoins*, Dec. 2–9, Cointelegraph (Dec. 10, 2020), Available here: <https://cointelegraph.com/news/finance-redefined-the-curious-implications-of-algorithmic-stablecoins-dec-2-9>.

¹⁴ UC Hope, *Algorithmic Stablecoins’ Instability Threatens Their Usefulness*, Cryptopolitan (Feb. 18, 2021), Available here: <https://www.cryptopolitan.com/algorithmic-stablecoins-instability/>.

products because the user's contractual right to the crypto asset may itself constitute a derivative often held by the platform until requested and transferred to the user. As suggested by the Canadian regulators, "in some jurisdictions, this right may be considered a security, such as an investment contract or evidence of indebtedness or an evidence of title to or interest in the assets or property of another person."¹⁵

3. **Cryptocurrency asset investment funds:** pool investors' funds to invest in cryptocurrency assets. As these types of investment funds involve the management of financial assets, usually with an expectation of sharing of returns, they should be considered financial products and subject to the same regulatory requirements as traditional managed investment schemes.

The overarching reason why these kinds of intermediated cryptocurrency assets and cryptocurrency asset services should be defined as financial products is to provide clarity and regulatory oversight in the rapidly evolving crypto asset market. This would ensure that investors are adequately protected and that market participants operate within a clear regulatory framework.

Q9) Some regulatory frameworks in other jurisdictions have placed restrictions on the issuance of intermediated crypto assets to specific public crypto networks. What (if any) are appropriate measures for assessing the suitability of a specific public crypto network to host wrapped real world assets?

One appropriate measure for assessing the suitability of a specific public cryptocurrency network to host wrapped real-world assets is to consider the network's security and reliability. This includes assessing the network's technical infrastructure, its consensus mechanism, and its track record for security breaches and vulnerabilities.

Another appropriate measure is to consider the regulatory framework and compliance requirements associated with the public cryptocurrency network. This includes assessing the network's legal and regulatory status in the relevant jurisdiction, as well as any applicable anti-money laundering and counter-terrorism financing requirements. Furthermore, it is essential to consider the governance structure of the public cryptocurrency network and the role of its stakeholders in overseeing its operations. This includes evaluating the level of decentralisation of the network and the transparency of its decision-making processes.

In conclusion, when assessing the suitability of a specific public cryptocurrency network to host wrapped real-world assets, it is crucial to consider a range of factors, including security, reliability, regulatory compliance, and governance structure.

Q10) Intermediated crypto assets involve crypto tokens linked to intangible property or other arrangements. Should there be limits, restrictions or frictions on the investment by consumers in relation to any arrangements not covered already by the financial services framework? Why?

There should be separate limits, restrictions or frictions on the investment by consumers in relation to intermediated cryptocurrency assets that are not covered by the financial services framework. This is because these assets present unique risks and challenges that require specialised regulatory oversight to

¹⁵ CSA / IIROC Staff Notice 21-327; CSA / IIROC Staff Notice 21-329, Feb. 7 & 9, 2022 available here: https://www.osc.ca/sites/default/files/pdfs/irps/csa_20200116_21-327_trading-crypto-assets.pdf and <https://www.iiroc.ca/news-and-publications/notices-and-guidance/joint-csaiiroc-staff-notice-21-329-guidance-crypto-asset-trading-platforms-compliance-regulatory>.

ensure that consumers are adequately protected. However, it is paramount that any restrictions be facilitated through regulatory mechanisms that are proportionate to the risk, size and complexity of the intermediated cryptocurrency asset whilst also attempting to strike a balance between protecting consumers and encouraging innovation.

In terms of specific limits, restrictions or frictions, we would recommend that these be tailored to the specific risks and characteristics of intermediated cryptocurrency assets, and take into account factors such as the complexity of the arrangements, the degree of investor protection, and the potential for fraud or misconduct. We also believe that any regulatory mechanisms that seek to restrict an individual's participation in any digital asset offering be proportional to the level of risk involved. For example, regulatory measures could include a carve out for certain disclosure requirements for any offerings that are under \$10,000.¹⁶

Q11) Some jurisdictions have implemented regulatory frameworks that address the marketing and promotion of products within the crypto ecosystem (including network tokens and public smart contracts). Would a similar solution be suitable for Australia? If so, how might this be implemented?

Implementing a regulatory framework that addresses the marketing and promotion of products within the cryptocurrency ecosystem in Australia would be a suitable solution to protect investors and promote market integrity. Such a framework could help prevent fraudulent activities through accountability on those creating marketing material and ensure that investors have access to accurate and reliable information.

For example, requiring cryptocurrency companies to disclose all relevant information regarding their products, including risks associated with investing in them. This could be achieved through mandatory disclosure requirements, such as prospectus or disclosure statement requirements, that would apply to all crypto products marketed in Australia.

Additionally, require cryptocurrency companies to obtain licences or registrations from relevant regulatory bodies, such as Australian Securities and Investments Commission (ASIC) or a newly formed regulator focused on the industry, before marketing or promoting their products. This would ensure only legitimate and reputable companies are marketing cryptocurrency products in Australia.

Finally, the regulatory framework could also include provisions for monitoring and enforcement, such as inspections and audits, to ensure that companies are complying with the disclosure and licensing requirements. This could be achieved through the allocation of resources to regulatory bodies for the purpose of monitoring and enforcing compliance with the regulatory framework.

Overall, we believe that implementing a regulatory framework that addresses the marketing and promotion of products within the cryptocurrency ecosystem would be a suitable solution for Australia, and could be achieved through a combination of mandatory disclosure requirements, licensing or registration requirements, and monitoring and enforcement provisions.

¹⁶ This is analogous to the small scale offerings that are available under s 708 of the *Corporations Act 2001* (Cth) whereby personal offers of a body's securities do not need to be disclosed to investors if certain conditions are met.

Q12) Smart contracts are commonly developed as ‘free open-source software’. They are often published and republished by entities other than their original authors. a) What are the regulatory and policy levers available to encourage the development of smart contracts that comply with existing regulatory frameworks? b) What are the regulatory and policy levers available to ensure smart contract applications comply with existing regulatory frameworks?

a)

The regulatory and policy levers available to encourage the development of smart contracts that comply with existing regulatory frameworks may include the issuance of guidance notes, more specific regulations, and industry standards. Whilst existing regulatory frameworks may be familiar to those working in highly regulated industries such as financial services or banking, our impression through discussions with clients is that there is insufficient regulatory certainty to allow them to determine which regulatory frameworks should apply to smart contracts (and, more broadly, to cryptocurrency and blockchain technology products as a whole).

Our view is that any proposed standards or publications for the purpose of encouraging smart contracts to be compliant with existing regulatory frameworks need to be written using language, terminology and concepts that are used by developers day-to-day and that are specific enough to be useful without requiring additional legal advice to interpret what those standards or publications mean. An industry body such as Blockchain Australia or the Australian DeFi Association which include members from businesses that are building smart contracts may be best placed to produce those standards or publications, and then engage in education and awareness campaigns (such as workshops and courses) targeted at developers and users of smart contracts to encourage compliance with existing regulatory frameworks.

From a practical perspective, encouraging software development work to be undertaken within Australia itself presents a different challenge. We have seen many of our clients choose to engage developers and coders outside of Australia, given that the talent pool of qualified and capable developers within the blockchain technology space in Australia is limited, and engaging those developers that are locally available can be prohibitively expensive. One policy lever that could be available to encourage software development work to be undertaken within Australia and in accordance with existing regulatory frameworks could be the introduction of tax offsets or other incentives such as the early stage venture capital limited partnership (ESVCLP)¹⁷ tax offset or the Digital Games Tax Offset (DGTO)¹⁸ currently being drafted. Although we have received feedback from clients that the DGTO legislation as presently drafted is not broad enough to be simple, easy and useful for clients to access.

b)

Our view is that where there are clear regulations and guidelines to be followed, ensuring compliance with those regulations is easier for participants as well as regulators. Aside from having those clear and specific regulations or standards as suggested in our reply to question 12(a) above, our view is that one important regulatory lever available to ensure smart contract applications comply with existing regulatory frameworks

¹⁷ Australian Taxation Office, ‘ESVCLP tax incentives and concessions’ Available here: <https://www.ato.gov.au/business/venture-capital-and-early-stage-venture-capital-limited-partnerships/esvclp-tax-incentives-and-concessions/>.

¹⁸ Draft Explanatory Statement, Income Tax Assessment Amendment (Digital Games Offset) Bill 2021: Measure for Consultation (Cth) Available here: <https://treasury.gov.au/sites/default/files/2022-03/c2022-255934-edr-exs.pdf>.

is to make sure that the body responsible for enforcement action is sufficiently familiar with the blockchain technology and cryptocurrency industry and related products, and well-resourced enough to be effective.

Q13) Some smart contract applications assist users to connect to smart contracts that implement a pawn-broker style of collateralised lending (i.e. only recourse in the event of default is the collateral). a) What are the key risk differences between smart-contract and conventional pawn-broker lending? b) Is there quantifiable data on the consumer outcomes in conventional pawn-broker lending compared with user outcomes for analogous services provided through smart contract applications?

a)

There are several key risk differences between smart-contract and conventional pawn-broker lending. Firstly, smart-contract applications are designed to operate in a decentralised and automated manner, and often include self-executing protocols rather than relying on a separate intermediary. From a risk perspective, the lack of a regulated intermediary (as pawn-brokers are) means that there is reduced regulatory oversight, potentially reduced accountability and greater difficulty enforcing contractual rights and obligations. Secondly, smart-contract applications operate on blockchain technology, which has its own inherent risks, including the potential for hacks, coding errors and other technological failures.

Finally, it is important to note that whilst both conventional pawn-broker lending and smart-contract pawn-broker style lending are typically over-collateralised lending arrangements, the price volatility of the underlying assets in the respective arrangements are vastly different. Whereas, for example, the agreed price of a pawned watch is unlikely to move significantly from one day to another, the price of crypto assets used for collateral in smart-contract pawn-broker style lending could significantly increase or decrease within the same period of time.

b)

We are not aware of quantifiable data in respect of consumer outcomes in conventional pawn-broker lending arrangements compared with smart-contract pawn-broker style lending. We note that a 2022 study published by ASIC found that pawn-broker lending posed several risks to consumers, including the potential for high interest rates, a lack of transparency and clarity in contractual terms, and potential for abusive or exploitative practices.¹⁹

Q14) Some smart contract applications assist users to connect to automated market makers (AMM). a) What are the key differences in risk between using an AMM and using the services of a crypto asset exchange? b) Is there quantifiable data on consumer outcomes in trading on conventional crypto asset exchanges compared with user outcomes in trading on AMMs?

¹⁹ Australian Securities and Investment Commission, '22-239MR ASIC warns brokers considering high-risk offers to retail investors (Media Release, 31 August 2022) Available here: <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2022-releases/22-239mr-asic-warns-brokers-considering-high-risk-offers-to-retail-investors/>.

a)

In comparing the risks associated with using an Automated Market Maker (AMM) versus the services of a cryptocurrency asset exchange, it is important to note several key distinctions. First, there is a liquidity risk associated with AMMs, as they rely on a pool of liquidity to execute trades, which can impact the price slippage.²⁰ In contrast, cryptocurrency asset exchanges typically have more liquidity depth, allowing for larger trades with less price slippage²¹. Secondly, AMMs rely on algorithmic pricing models, which may not always be accurate in volatile markets, leading to price fluctuations and potential losses.²² Conversely, cryptocurrency asset exchanges have more traditional market-making services with human intervention, which may offer more stable prices during high volatility. Finally, in AMMs, trades are executed automatically, with no intermediary managing the trade, meaning there is no counterparty risk.²³ In contrast, cryptocurrency asset exchanges involve a third-party intermediary, which introduces counterparty risk, such as the risk of theft or fraud.

b)

It is worth noting that there is limited quantifiable data on consumer outcomes in trading on conventional cryptocurrency asset exchanges compared to user outcomes in trading on AMMs, and comparisons between the two types of exchanges are difficult due to differences in their trading mechanisms. One way to compare the two is to examine the volume and value of transactions on both types of exchanges, with data from CoinMarketCap suggesting that the daily trading volume of the top ten centralised exchanges is typically higher than the daily trading volume of the top ten AMMs.²⁴ However, this does not necessarily indicate better outcomes for users on centralised exchanges compared to AMMs. Another way to compare the two is to examine the fees charged by each type of exchange. AMMs generally charge lower fees than centralised exchanges²⁵, which may make them more attractive to users. However, lower fees may also indicate lower liquidity, which could lead to higher price slippage and worse trading outcomes.

Overall, more research is required to draw meaningful conclusions regarding consumer outcomes in trading on conventional cryptocurrency asset exchanges compared with user outcomes in trading on AMMs, given the limited available data.

²⁰ Chainlink, 'What are Automated Market Makers' Available here: <https://chain.link/education-hub/what-is-an-automated-market-maker-amm#:~:text=Liquidity%20is%20essential%20for%20AMMs%20to%20function%20properly.,AMM%2C%20leading%20to%20capital%20inefficiency%20and%20impermanent%20loss.>

²¹ CoinMarketCap, 'Liquidity Score (Market Pair, Exchange)' Available here: <https://support.coinmarketcap.com/hc/en-us/articles/360043836931-Liquidity-Score-Market-Pair-Exchange->

²² Harvard Business Review, 'The Pitfalls of Pricing Algorithms' Available here: <https://hbr.org/2021/09/the-pitfalls-of-pricing-algorithms>

²³ Coindesk, 'What Is an Automated Market Maker? - AMMs Explained' Available here: <https://www.coindesk.com/learn/what-is-an-automated-market-maker/>

²⁴ CoinMarketCap, 'Top Cryptocurrency Decentralized Exchanges' Available here: <https://coinmarketcap.com/rankings/exchanges/dex/>

²⁵ Uniswap, 'The Dominance of Uniswap v3 Liquidity' Available here: <https://uniswap.org/blog/uniswap-v3-dominance>